2. Opportunism and Asset Specificity

18. Oliver E. Williamson defines *opportunism* as "self-interest seeking with guile"[21] and describes utility regulation as a "highly incomplete form of long-term contracting" in which the terms are adapted to "changing circumstances" to ensure the supplier of a fair rate of return.[22] Simply auctioning franchises in the manner that Harold Demsetz proposed[23] creates difficulties, Williamson argues, because parties to the franchise agreement could behave opportunistically and renege on their contractual promises. He emphasizes the possibility that cable television operators would bid low on the franchise and later raise prices to take advantage of the regulator's sunk costs of searching for a franchise operator.[24] Conversely, empirical evidence indicates that cities awarding cable franchises may take advantage of the cable operator's irreversible investment in transmission facilities.[25]

19. The problem of regulatory opportunism stems from the fact that regulatory assets, including expenditures for plant and equipment and capitalized outlays to perform duties mandated by regulators, are likely to be transaction-specific. That is, the assets have little value outside the regulatory transaction. Although they used different terminology, scholars on regulation have recognized the problem of asset specificity since the early part of the twentieth century. In 1934 John Bauer wrote of investment by public utilities: "Capital is largely embodied in fixed structures which are useless except for their special purposes."[26] Many years later, Paul Milgrom and John Roberts defined an asset's degree of specificity to be "the fraction of [the asset's] value that would be lost if it were excluded from its major use."[27] Applying the Milgrom-Roberts measure to Bauer's assessment of public utility investment would imply 100 percent asset specificity. Even if public utility investment were not quite so specific, it is easy to understand why William-

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21. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 26 (Free Press 1975); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 47 (Free Press 1985).

22. Oliver E. Williamson, *Franchise Bidding for Natural Monopolies—in General and with Respect to CATV*, 7 BELL J. ECON. 73, 91 (1976) [hereinafter *Franchise Bidding*].

23. Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55 (1968).

24. Williamson, *Franchise Bidding*, *supra* note 22, at 92.

25. *See* Mark A. Zupan, *Cable Franchise Renewals: Do Incumbent Firms Behave Opportunistically?*, 20 RAND J. ECON. 473 (1989).

26. John Bauer, *Public Utilities: United States and Canada*, *in* 12 ENCYCLOPAEDIA OF THE SOCIAL SCIENCES 677, 680 (Edwin R. A. Seligman & Alvin Johnson eds., Macmillan Co. 1934).

27. PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 307 (Prentice Hall 1992).

son has observed that "asset specificity is the big locomotive to which transaction cost economics owes much of its predictive content."[28] He notes that markets that are contestable are those without asset specificity, so that "contestability theory and transaction cost economics are looking at the same phenomenon—the condition of asset specificity—through the opposite ends of the telescope."[29]

20. Technological changes that affect the degree of asset specificity are facilitating the transition from regulation to competition being observed in markets traditionally served by public utilities. The regulatory contract that was suited to an industry with significant asset specificity is not suited to an industry in which asset specificity has declined considerably. The problem of incompatibility between the degree of asset specificity and the regulatory regime arises in the transition to competition: Incumbent utilities have not yet recovered the costs of their assets that are specific to a regulated market, and entrants meanwhile can invest in facilities that have considerably less asset specificity (wireless telecommunications, for example) or can provide service with minimal investment (resale of incumbent telecommunications services, for example).

21. It would breach the regulatory contract for the regulator to make unilateral changes in regulation that might prevent a utility from recovering the costs of investments that it made to discharge its regulatory obligations to serve. Contractual protections of the interests of the utility and its investors exist so that the state and private companies can continue to make agreements requiring investments in highly specialized capital. Analogously, Paul Joskow has studied the nature of the long-term contracts by which coal mines supply electric utilities with coal.[30] He found that, because that contractual relationship entails durable transaction-specific investments by both parties, the supply contracts have detailed price-escalation clauses to reflect changes in the cost of supplying coal. Rather than set specific prices, the contracts establish the framework for determining how price adjustments should be made in the event that circumstances change in a way that the parties could not have foreseen when entering into the contract. Just as the institution of

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28. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM, *supra* note 21, at 56.

29. *Id.* at 56 n.14.

30. Paul L. Joskow, *Vertical Integration and Long-Term Contracts: The Case of Coal-Burning Electric Generating Plants*, 1 J.L. ECON. & ORG. 33 (1980); Paul L. Joskow, *Contract Duration and Durable Transaction-Specific Investments: The Case of Coal*, 77 AM. ECON. REV. 168 (1987); Paul L. Joskow, *Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence*, 4 J.L. ECON. & ORG. 95 (1988).

contract law reduces the cost of forming private agreements that entail transaction-specific investments, so agreements between the state and private companies depend on analogous contractual protections to reduce and allocate the risk of cost recovery for specialized assets that cannot be salvaged if the contract is not performed.

22. As with private contracts, the regulatory contract is designed to address "holdup" problems. By incurring substantial capital expenditures to perform its obligation to serve, the utility is vulnerable to confiscation. In the absence of contract enforcement, the utility is at the mercy of the regulatory authority: By lowering rates to levels that do not allow a full recovery of costs, after the facilities have been created, a regulator could take advantage of the utility and its investors. A company supplying telecommunications services can raise or lower its posted prices without incurring more than the costs of communicating the new tariffs to customers. The regulated rates are thus much more flexible than are the utility's capital facilities in contrast since those are irreversible, market-specific investments. To the extent that they were tailored to meet regulatory obligations to serve, the utility's investments need not be fully recovered in a competitive market setting. That means that the regulatory contract is necessary to protect the regulated utility from regulatory "holdup."

23. The opening of telecommunications markets to competition provides a temptation for regulators to behave in an opportunistic manner. The utilities have already constructed their network facilities. They will keep those facilities in operation as long as revenues cover their operating costs, even if revenues are not sufficient to allow even partial recovery of capital costs.

3. Credible Commitments

24. Economic theory widely recognizes that commitments made in bargaining situations influence the behavior of other actors only to the extent that the person making such commitments is credibly bound (by himself or others) to honoring them.[31] The notion of enforceable agreements plays a similar role in

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31. *See, e.g.*, MILGROM & ROBERTS, *supra* note 27, at 131; OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 120–44 (Oxford University Press 1996); WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM, *supra* note 21, at 167; THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT (Oxford University Press 1960).

regulated industries as it does in competitive markets. As Pablo T. Spiller and others have shown both theoretically and empirically, the level of investment in long-lived infrastructure undertaken by a regulated (or recently privatized) public utility depends critically on regulatory institutions' having been designed to ensure the credibility of the regulator's commitments that it will not act opportunistically once the utility has placed those nonsalvageable assets into service.[32] The President's Council of Economic Advisers has made the same argument concerning recovery of stranded costs:

> [R]ecovery should be allowed for legitimate stranded costs. The equity reason for doing so is clear, but there is also a strong efficiency reason for honoring regulators' promises. Credible government is key to a successful market economy, because it is so important for encouraging long-term investments. Although policy reforms inevitably impose losses on some holders of existing assets, good policy tries to mitigate such losses for investments made based on earlier rules.[33]

The utility's investors would not be willing to commit vast amounts of capital to carry out an obligation to serve unless the regulator's offer of an opportunity to earn a fair rate of return were credible. Regulated utilities relied upon those contractual assurances in planning and carrying out their investment and service plans. Conversely, the regulator would not be willing to provide a franchise protected by entry regulation and to authorize the utility's pricing and investment plans unless the utility's promises to provide services were credible. The legal and public policy context in which the regulatory process operates provides guarantees to the parties to the regulatory contract.

25. As with private contracts, the regulatory contract must involve consideration, for the agreement is voluntary. The first utilities did not spring into existence as a result of some government conscription of private capital. The regulated utility submits to various regulatory restrictions including price regulations, quality-of-service requirements, and common carrier regulations. In return, the regulated firm receives a protected franchise in its service territory, and its investors are allowed an opportunity to earn reve-

32. Pablo T. Spiller, *Institutions and Regulatory Commitment in Utilities' Privatizations*, 2 INDUS. & CORP. CHANGE 387 (1993); Brian Levy & Pablo T. Spiller, *The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Five Country Studies of Telecommunications Regulation*, 10 J.L. ECON. & ORG. 201 (1994); Shane Greenstein, Susan McMaster & Pablo T. Spiller, *The Effect of Incentive Regulation on Infrastructure Modernization: Local Exchange Companies' Deployment of Digital Technology*, 4 J. ECON. & MGMT. STRATEGY 187 (1995).

33. 1996 ECONOMIC REPORT OF THE PRESIDENT 187 (Government Printing Office 1996).

nues subject to a rate-of-return constraint. Without the expectation of earning a competitive rate of return, investors would not be willing to commit funds for establishing and operating the utility. The funds are committed to provide services to the customers of the regulated utility. Once the utility invests those funds, the long depreciation schedules typical in telecommunications regulation credibly commit the utility to performing its obligations under the regulatory contract by denying it the opportunity to recover its capital before the end of its useful life.

B. The Principal Components of the Regulatory Contract

26. The three components of the regulatory contract are entry controls, rate regulation, and utility service obligations.[34] Entry controls have traditionally limited competition for the utilities and allowed them the opportunity to earn a fair rate of return on their investments while conforming to rate regulation and regulatory service obligations. The elimination of regulatory entry barriers to achieve the benefits of competition represents a fundamental change in the terms of the regulatory contract. To avoid confiscatory outcomes, those changes need to be counterbalanced by altering both the responsibilities and compensation for the incumbent utilities.

27. A common misunderstanding of the regulatory contract is that an essential component of that agreement is the government's grant of a monopoly to the investor-owned utility. The grant may take the form of an exclusive franchise or a statutory prohibition on competitive entry. To the contrary, the regulatory contract does *not* require monopoly, and the misapprehension that it does, in turn, supplies the erroneous premise for two misplaced arguments. The first is the assertion that those who defend the regulatory contract are necessarily opposed to competition and unconditionally maintain that, by itself, the government's introduction of competition into the market in question would constitute breach of the regulatory contract. The second misplaced argument is the assertion that one can disprove the existence of the regulatory contract in a given state by pointing to the existence there of a statute or state constitutional provision that forbids the state or any of its municipalities from granting an exclusive franchise. Neither of those two arguments

34. These components of the regulatory contract are discussed more fully in SIDAK & SPULBER, *supra* note 11, at 113–29.

is correct.

28. Suppose that a state not only forbade exclusive franchises but also failed to create—by statute, common law, or regulatory practice of long standing—any alternative cost recovery mechanism that credibly assured the utility that the regulator would provide the utility the opportunity to recover its irreversible, nonsalvageable investments. In that institutional setting, a private company would be reluctant to contract with municipalities for the long-term supply of any amount of service that would necessitate any incremental investment in nonsalvageable assets; and even if the company *were* willing enter into such a contract, investors would be unwilling to supply the company with the requisite capital unless they were paid a risk premium substantial enough to compensate for the risk that the firm might never recover the capital used to make those investments in nonsalvageable assets and that the firm might never receive a competitive return on that capital. Investors routinely demand that sort of risk premium from irreversible investments in third-world countries that suffer from political instability and correspondingly unreliable judicial and regulatory institutions for the protection of private property. Most important, consumers suffer under such circumstances because they ultimately pay the risk premium that is necessary to attract the investment required for the utility to render service and because they will bear the disruption in service if regulatory instability induces the public utility to disinvest.

29. Clearly, therefore, the existence of a statute or state constitutional provision that forbids the state or any of its municipalities from granting an exclusive franchise does not disprove the existence of the regulatory contract in that state. It is a factual matter beyond any dispute that some states, such as Texas, forbid the grant of an exclusive franchise.[35] The existence of such a prohibition, however, is hardly evidence that the state does not have a regulatory contract. All that such a fact proves is that the state has selected a different means by which to achieve the ends for which franchise exclusivity is the chosen means in other states. The common objective in the two cases is to create the opportunity for the utility to recover the prudently incurred costs of irreversible, nonsalvageable investments that it made to discharge its obligation

35. TEX. CONST. art. I, § 26. For a 1913 survey of the limitations on the grant of exclusive franchises, see OSCAR L. POND, A TREATISE ON THE LAW OF PUBLIC UTILITIES OPERATING IN CITIES AND TOWNS §§ 117-31, 156-71 (Bobbs-Merrill Co. 1913).

to serve customers within its service area. For example, a municipality or state, while not granting exclusivity to the incumbent utility, may nonetheless refrain from taking actions that would threaten the firm's recovery of nonsalvageable investments. In the absence of rate rebalancing, the most obvious way for the municipality or state to preserve a reasonable opportunity for the incumbent utility to recover its costs would be to permit entry only by firms that will either assume public service obligations comparable to the incumbent's or contribute their appropriate share to the funding of such obligations. That limitation on the discretion of the licensing authority may include the statutory directive to the public utilities commission not to grant an overlapping certificate of public necessity without good cause. In Texas, for example, the Public Utility Regulatory Act of 1995 provides that the Public Utilities Commission of Texas shall grant a certificate of convenience and necessity after considering not only "the adequacy of existing service" and "the need for additional service," but also the effect of the grant on a number of factors, including its effect "on any public utility of the same kind already serving the proximate area."[36]

30. Further, the government's introduction of competition into the regulated market in itself would not breach the regulatory contract. Entry regulation is simply a means to an end; it is not the end in itself. The appropriate objective—the objective that advances economic efficiency and consumer welfare—is for the regulator to provide a credible mechanism by which the utility will have the opportunity to recover the costs of (and a competitive return *on*) its irreversible, nonsalvageable investments over the course of their useful lives. If a state in the past has chosen franchise exclusivity as the mechanism to achieve that objective but now wants to reverse course and allow open entry, then it must simultaneously introduce an alternative policy that is equally efficacious in creating the opportunity for achieving that cost-recovery objective. In short, a breach of the regulatory contract does *not* necessarily occur when the state abolishes entry regulation; but a breach *does* necessarily occur when the state abolishes entry regulation without simultaneously imposing an alternative policy that will achieve the same cost-recovery objective for which entry regulation was originally intended.

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36. TEX. REV. CIV. STAT. ANN., art. 1446c-0, § 2.255(c).

C. The Duration of the Regulatory Contract

31. How long does the regulatory contract last? Contracts in general exist because performance takes time. Thus, the duration of the contract reflects the time required for performance to be completed. The duration of the regulatory contract corresponds to the economic lifetime of the assets employed by the utility to perform its service obligations. The regulatory contract typically lasts a long time because the assets employed in network industries are irreversible and market-specific with a long lifetime. The utility performs its contractual obligations during the period of time that its facilities are used and useful. Consumers continue to receive the services of those assets even after the costs have been fully recovered through amortization.

32. The high costs of investment in network facilities and the extended economic lifetime of those facilities make it desirable for consumers to pay for services as they are received. Thus, investors in regulated utilities not only finance the firm's investment, but also implicitly finance the payments of consumers. Consumers receive the services of long-lived assets in a manner similar to leasing capital equipment.

33. Because of the irreversible nature of investment, the duration of the regulatory contract also depends on the buyer's performance. Thus, the regulatory contract lasts until the firm has had a reasonable opportunity to recover the nonsalvageable investments that it made to provide service to the public. In contracts with explicit durations, that concern for cost recovery manifests itself in a lengthy term of the utility's franchise. The legal answer to the question of the regulatory contract's duration mirrors that economic reasoning. Oscar L. Pond wrote in his 1913 treatise that "the erection and maintenance of [public utility] systems require so large an investment that private capital will not undertake such enterprises under franchises running for unreasonably short periods of time."[37] Moreover, Pond noted, "the property so used can not be easily turned or converted into cash," a clear recognition of the risk to the utility of the asset specificity inherent in its investment in infrastructure.[38]

34. It bears emphasis, particularly in the absence of an explicitly defined duration for the contract, that the regulator, by imposing depreciation policies (or other regulatory policies) that cause cost recovery to

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37. POND, *supra* note 35, at § 120 at 158 .
38. *Id.* § 121 at 158.

lag behind actual economic depreciation, in effect extends the duration of the contract until such time as the utility has received the reasonable opportunity to recoup its true costs—both operating costs and capital costs. Irston R. Barnes described two possible legal forms consistent with that economic proposition. The first was a *perpetual franchise*. Though a franchise was "seldom made perpetual by its terms," Barnes noted, "if the franchise is silent with respect to its duration and if there are not general laws of the state imposing a limitation with respect to their duration, the courts may hold the franchise to be perpetual."[39]

35. The second form was the *indeterminate permit* or *terminable franchise*. Under such a franchise, which eighteen states permitted at the time that Barnes wrote in 1942, "[t]he utility continues to enjoy the privileges of the franchise until the municipality acts to take over the property," which as a practical matter "means that the franchise endures as long as the service continues to be satisfactory."[40] A public utility that satisfactorily performed its public service obligations would have "what is in effect a perpetual franchise," subject to the municipality's option to terminate the franchise and "pay the purchase price of the property."[41] The terminable franchise closely resembles the long-term relational contracting that Goldberg, Williamson, and other economists would describe several decades later. Barnes seemed to consider the terminable franchise to be the most efficient contracting form of his day for balancing the competing interests of the utility, the municipality, and consumers. The benefits to the utility were lessened risk for its asset-specific investment and, hence, a lower cost of capital:

> The company is secure in the possession and operation of its property. . . . [T]he investment of capital is readily induced on favorable terms. Expenditures for improvements and extensions are willingly undertaken, since all of the legitimate investment must be fully compensated if the municipality decides to take possession of the property.[42]

The terminable franchise gave the municipality "full control with respect to the future conduct of the

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39. IRSTON R. BARNES, THE ECONOMICS OF PUBLIC UTILITY REGULATION 219 (F. S. Crofts & Co. 1942) (citing Owensboro *v.* Cumberland Tel. & Tel. Co., 230 U.S. 58 (1913); Ohio Pub. Serv. Co. *v.* Ohio, 274 U.S. 12 (1927)).

40. *Id.* at 221. The states were Arkansas, California, Colorado, Connecticut, Idaho, Illinois, Indiana, Kansas, Louisiana, Maryland, Missouri, Montana, New Hampshire, North Dakota, Ohio, South Carolina, Vermont, and Wisconsin. *Id.* at 212 n.3. The two other types of franchises that Barnes described were the *long-term franchise*, lasting twenty to fifty years, and the *short-term franchise*, lasting ten years or fewer but frequently having a virtually automatic privilege of renewal for an equal number of years. *Id.* at 219–20.

41. *Id.* at 221. "It is therefore of crucial importance," Barnes added, "that the franchise define precisely the procedure by which the property shall be valued." *Id.*

42. *Id.*

utility."[43] At the same time, however, the municipality forbore from holding periodic proceedings to renew the franchise. The municipality thus avoided the "bickering and controversy" over franchise renewal that one can imagine could have signaled opportunism by the municipality.[44]

D. The Regulatory Contract in the Supreme Court

36. The understanding of utility regulation as contract permeates a number of Supreme Court decisions from the late nineteenth and early twentieth centuries. Those decisions were usually unanimous and are striking for the sophistication with which they described in nontechnical terms the economic rationale for the regulatory contract and based their legal conclusions on such reasoning. Our purpose in discussing the following decisions by the Court is not to endorse the logic of particular legal doctrines, some of which the Court has abandoned since the *Lochner* era, but rather to show as a *factual* matter that in various kinds of cases predating the rise of the state regulatory commission the Court regarded the municipal franchise as an enforceable contract.

1. *New Orleans Water Works*

37. In 1885 the Court held unconstitutional, in *New Orleans Water Works Co.* v. *Rivers*, a local government's ordinance that infringed upon the exclusive rights that the state legislature granted a water company.[45] The Louisiana legislature in 1877 granted the New Orleans Water-Works Company the exclusive right to provide water to the city of New Orleans for fifty years. In 1882 the city council of New Orleans passed an ordinance to allow an individual to lay pipes to provide his New Orleans hotel with water. The Court upheld the exclusivity of the New Orleans Water-Works' franchise and, in a unanimous opinion by Justice John Marshall Harlan, reasoned:

> The right to dig up and use the streets and alleys of New Orleans for the purpose of placing pipes and mains to supply the city and its inhabitants with water is a franchise belonging to the State, which she could grant to such persons or corporations, and upon such terms, as she deemed best for the public interests. And as the object to be attained was a public one, for which the State could make provision by legislative enactment, the grant of the franchise could be accompanied with such exclusive privileges to the grantee, in respect of the subject of the

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43. *Id.*
44. *Id.*
45. 115 U.S. 674 (1885).

> grant, as in the judgment of the legislative department would best promote the public health and the public comfort, or the protection of public and private property. Such was the nature of the plaintiff's grant, which, not being at the time prohibited by the constitution of the State, was a contract, the obligation of which cannot be impaired by subsequent legislation, or by a change in her organic law. It is as much a contract, within the meaning of the Constitution of the United States, as a grant to a private corporation for a valuable consideration, or in consideration of public services to be rendered by it, of the exclusive right to construct and maintain a railroad within certain lines and between given points, or a bridge over a navigable stream within a prescribed distance above and below a designated point.[46]

In the companion case, *New Orleans Gas Co.* v. *Louisiana Light Co.*, a unanimous Court, again speaking through Justice Harlan, recognized that a state may exercise its police power to protect the health, morals, and safety of its citizens, but the power to regulate is tempered by an inability to impair contractual obligations.[47] On facts similar to those in *New Orleans Water Works*, the Court observed: "That the police power . . . is restricted . . . is further shown by those cases in which grants of exclusive privileges respecting public highways and bridges over navigable streams have been sustained as contracts, the obligations of which are fully protected against impairment by State enactments."[48]

2. *Walla Walla Water*

38. In *Walla Walla City* v. *Walla Walla Water Co.* the Court extended its defense of contract to a municipal franchise.[49] In 1883 the legislature of Washington Territory incorporated the city of Walla Walla. One of its enumerated powers under the charter was the power to provide water for the city, as well as the right to permit the use of city streets for the purpose of laying pipes for furnishing such supply. Pursuant to its power, the city of Walla Walla by contract granted to the Walla Walla Water Company in 1887 the right to lay and maintain water mains and related infrastructure for twenty-five years. The water company accepted and complied with all conditions in the contract. In 1893, however, the city passed an ordinance to provide for the construction of a system of water works to supply the city with water. The question thus arose whether the federal court had jurisdiction to decide whether the city had unconstitutionally impaired the obligation of its franchise contract. On his way to concluding that the federal courts did indeed have jurisdiction, Justice Henry

46. *Id.* at 681.
47. 115 U.S. 650 (1885).
48. *Id.* at 661.
49. 172 U.S. 1 (1898).

B. Brown wrote for a unanimous panel that "this court has too often decided for the rule to be now questioned, that the grant of a right to supply gas or water to a municipality and its inhabitants through pipes and mains laid in the streets, upon condition of the performance of its service by the grantee, is the grant of a franchise vested in the State, in consideration of the performance of a public service, and after performance by the grantee, is a contract protected by the Constitution of the United States against state legislation to impair it."[50]

39. Although the city's franchise did not confer a monopoly, Walla Walla Water's contract specifically stipulated that the city would not compete with the company. The city argued that the noncompete provision made the contract void as against public policy. But the Court rejected the argument and interpreted that provision, along with an eminent domain provision, as ancillary restraints that protected the franchisee's opportunity to recover the cost of its investment in infrastructure:

> There was no attempt made to create a monopoly by granting an exclusive right to this company, and the agreement that the city would not erect water works of its own was accompanied, in section 8 of the contract, with a reservation of a right to take, condemn and pay for the water works of the company at any time during the existence of the contract. Taking sections 7 and 8 together, they amount simply to this: That if the city should desire to establish water works of its own it would do so by condemning the property of the company and making such changes in its plant or such additions thereto as it might deem desirable for the better supply of its inhabitants; but that it would not enter into a direct competition with the company during the life of the contract. As such competition would be almost necessarily ruinous to the company, it was little more than an agreement that the city would carry out the contract in good faith.[51]

The Court regarded the noncompete provision as "a natural incident to the main purpose of the contract,"[52] without which a private company would not voluntarily make the substantial asset-specific investments required to provide water service:

> In establishing a system of water works the company would necessarily incur a large expense in the construction of the power house and the laying of its pipes through the streets, and, as the life of the contract was limited to twenty-five years, it would naturally desire to protect itself from competition as far as possible, and would have a right to expect that at least the city would not itself enter into such competition. It is not to be supposed that the company would

50. *Id.* at 8-9. "It is true that in these cases the franchise was granted directly by the state legislature, but it is equally clear that such franchises may be bestowed upon corporations by the municipal authorities, provided the right to do so is given by their charters. State legislatures may not only exercise their sovereignty directly, but may delegate such portions of it to inferior legislative bodies as, in their judgment, is desirable for local purposes." *Id.*

51. *Id.* at 17.

52. *Id.*

> have entered upon this large undertaking in view of the possibility that, in one of the sudden changes of public opinion to which all municipalities are more or less subject, the city might resolve to enter the field itself—a field in which it undoubtedly would have become the master—and practically extinguish the rights it had already granted to the company.[53]

In short, the Court articulated in *Walla Walla Water* the same concern over contractual opportunism that emerged three-quarters of a century later as a guiding principle in the economic analysis of utility regulation.

3. *Russell* v. *Sebastian*

40. In *Russell* v. *Sebastian*, the Court, in 1914, reiterated that concern over contractual opportunism and specifically endorsed a public service corporation's expectation of a profitable rate of return on its investment.[54] Writing for a unanimous Court, Justice Charles Evans Hughes reasoned that a private enterprise accepted a franchise offer with the expectation to earn a profitable rate of return on the investments required to fulfill its obligations under the franchise contract.[55] The Court viewed such an expectation to be inherent in the parties' bargained-for exchange. *Russell* held that a state constitutional amendment and subsequent municipal ordinances impaired contract rights vested in the Economic Gas Co. by a franchise grant entailed in section 19 of article XI of California's 1879 constitution, which provided:

> In any city where there are no public works owned and controlled by the municipality for supplying the same with water or artificial light, any individual, or any company duly incorporated for such purpose, under and by authority of the laws of this state, shall, under the direction of the superintendent of streets, or other officer in control thereof, and under such general regulations as the municipality may prescribe, for damages and indemnity for damages, have the privilege of using the public streets and thoroughfares thereof, and of laying down pipes and conduits therein, and connections therewith, so far as may be necessary for introducing into and supplying such city and its inhabitants, either with gaslight, or other illuminating light, or with fresh water for domestic and all other purposes, upon the condition that the municipal government shall have the right to regulate the charges thereof.[56]

Justice Hughes remarked upon the informal and spontaneous manner in which offer and acceptance of the regulatory contract would occur under such an ordinance:

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53. *Id.* at 17–18.
54. 233 U.S. 195, 210 (1914).
55. *Id.* Justice Horace H. Lurton took no part in the decision.
56. *Id.* at 198–99. Economic Gas also claimed that the constitutional amendment and ordinance deprived the company of property without due process in violation of equal protection of the laws under the Fourteenth Amendment. *Id.* at 199–200. The Court did not reach that issue.

> It is pointed out that the language of the provision was general both with respect to persons and to places; that it embraced all the cities in the State; and that *it did not provide for any formal or written acceptance of the offer*. But the lack of a requirement of an acceptance of a formal character did not preclude acceptance in fact. . . . [W]hen as to such a city the offer was accepted, the grant became as effective as if it had been made specially to the accepting individual or corporation.[57]

Justice Hughes's reasoning sheds light on the current debate over the regulatory contract. In that debate, some who oppose compensating utilities for their stranded costs dispute the very existence of the regulatory contract because, they argue, no formal writing documents its formation.[58]

41. In 1909 Economic Gas began its manufacture and distribution of gas to supply the city of Los Angeles with lighting under a claim of right based upon section 19.[59] In 1911 California amended that section of its constitution to allow municipalities to prescribe conditions and regulations upon such corporations.[60] In pursuance of the amendment, the city of Los Angeles adopted two ordinances. The first barred anyone from exercising any franchise or privilege to lay or maintain utility pipes without first obtaining a grant from the city,[61] and the second outlawed street excavation without written permission from the public works board.[62]

42. The determinative issue in *Russell* was the nature and extent of the rights that Economic Gas acquired under section 19 of California's 1879 constitution upon accepting the franchise offer. The state contended that the scope of Economic Gas's acceptance, and hence the scope of its operations, were limited to the range of streets in use at the time of the 1911 constitutional amendment.[63] Economic Gas claimed that it would lose $2,000 per month if the state were to confine the company's operations solely to the streets in use as of 1911.[64]

43. For three reasons the Court concluded that Economic Gas had a contractual right to the larger service area that it believed its franchise entailed. First, the Court held that accepting the state's offer would

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57. *Id.* at 203 (emphasis added).

58. For an analysis of the related question of the voidability of the regulatory contract, see the discussion of the Statute of Frauds in SIDAK & SPULBER, *supra* note 11, at 201–10.

59. 233 U.S. at 200.

60. *Id.* at 198–99.

61. *Id.* at 199.

62. *Id.*

63. *Id.* at 202.

64. *Id.* at 201.

oblige the company to supply the city with light.[65] That obligation, in turn, would require the company to make considerable investments to construct permanent reservoirs with suitable storage capacity, to build plants large enough to meet reasonably anticipated demands, and to lay conduits necessary for distribution.[66] Second and more notably, the Court found that when an offer of a franchise entailed extensive investment by the franchisee, either explicitly or implicitly, the right of the franchisee to a chance of profit was inherent in the offer, and the chance of profit was essential to the efficacy of an enterprise.[67] Finally, the Court reasoned that because firms evaluated business ventures on the basis of calculations of future growth and expansion, a utility would necessarily expect that the city would open new streets and extend old ones over time—especially where the utility was obligated to extend service throughout the city as reasonable demands required.[68] Economic Gas's construction of facilities capable of supplying gas to a territory much larger than that supplied before the 1911 ordinance evidenced the company's future intentions; indeed, the company had invested $100,000 more than would have been necessary to supply only the inhabitants reached by the pipes in 1911.[69] Hence, the Court concluded that the right to lay the pipes carrying the gas necessary to provide light to Los Angeles inhabitants was "absolutely essential to the undertaking"[70] and that the grant was therefore binding as an entirety and "not foot by foot, as pipes were laid."[71]

44. Justice Hughes relied heavily on notions of detrimental reliance and investment-backed expectations. Such considerations underlay his emphatic rhetoric concerning contract formation:

> When the voice of the State declares that it is bound if its offer is accepted, and the question simply is with respect to the scope of the obligation, we should be slow to conclude that only a revocable license was intended. Moreover the provision plainly contemplated the establishment of a plant devoted to the described public service and an assumption of the duty to perform that service. That the grant, resulting from an acceptance of the State's offer, constituted a contract, and vested in the accepting individual or corporation a property right, protected by the Federal Constitution, is not open to dispute in view of the repeated decisions of this court.[72]

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65. *Id.* at 209.
66. *Id.* at 206.
67. *Id.* at 208.
68. *Id.* at 209.
69. *Id.* at 200.
70. *Id.*
71. *Id.* at 207–08.
72. *Id.* at 204.

Having shown that formation of the regulatory contract had occurred, Justice Hughes turned to interpreting the contract and emphasized that the Court would not permit rules of construction thereupon to suck the content from the agreement. After conceding the black-letter rule that "public grants are to be construed strictly in favor of the public" and that "ambiguities are to be resolved against the grantee," Justice Hughes emphasized that "this principle of construction does not deny to public offers a fair and reasonable interpretation, or justify the withholding of that which it satisfactorily appears the grant was intended to convey."[73] Instead, he insisted on giving "a practical, common-sense construction" to the regulatory contract.[74] That common-sense construction led Justice Hughes to emphasize the potential for stranded costs to arise if the state were to act opportunistically with respect to the investments that Economic Gas had made to perform the contract:

> The breadth of the offer was commensurate with the requirements of the undertaking which was invited. The service to which the provision referred was a community service. It was the supply of a municipality—which had no municipal works—with water or light. This would involve, in the case of water-works, the securing of sources of supply, the provision of conduits for conveying the water to the municipality, and the permanent investment in the construction of reservoirs with suitable storage capacity; and, in the case of gas-works, the establishment of a manufacturing plant on a scale large enough to meet the demands that could reasonably be anticipated. *But water-works and gas-works constructed to furnish a municipality with water or light would, of course, be useless without distributing systems;* and the right of laying in the streets the mains needed to carry the water or gas to the inhabitants of the community was absolutely essential to the undertaking as a practical enterprise. This, the constitutional provision recognized. It was clearly designed to stop favoritism in granting such rights, not to withhold them. It is not to be supposed that it was expected that water-works and gas-works of the character required to supply cities would be erected without grants of franchises to use the streets for laying the necessary distributing pipes. . . . The scheme of the constitutional provision was not to make it impossible to secure such grants, or to restrict the street rights to be acquired, but, as already stated, to end the existing abuses by making these grants directly through the constitution itself instead of permitting them to be made by the legislature or by municipalities acting under legislative authority.[75]

Justice Hughes rejected the proposition that "the investment in extensive plants—in the construction of reservoirs, and in the building of manufacturing works—was invited without any assurance that the laying of the distributing system could be completed or that it could even be extended far enough to afford any chance of profit."[76] Echoing the reasoning of economists more than half a century later, Justice Hughes concluded

73. *Id.* at 205.
74. *Id.*
75. *Id.* at 206–07.
76. *Id.* at 208.

his opinion for the Court by once more underscoring the significance of investment as an act of contract formation: "The company, by its investment, had irrevocably committed itself to the undertaking and its acceptance of the offer of the right to lay its pipes, so far as necessary to serve the municipality, was complete."[77]

4. *Cedar Rapids Gas Light*

45. In a 1912 decision concerning municipal regulation of gas prices, *Cedar Rapids Gas Light Co.* v. *City of Cedar Rapids*, Justice Oliver Wendell Holmes wrote for a unanimous Supreme Court that such regulation "has to steer between Scylla and Charybdis,"[78] for it resulted from bilateral bargaining in the shadow of takings jurisprudence:

> On the one side if the franchise is taken to mean that the most profitable return that could be got, free from competition, is protected by the Fourteenth Amendment, then the power to regulate is null. On the other hand if the power to regulate withdraws the protection of the Amendment altogether, then the property is nought. This is not a matter of economic theory, *but of fair interpretation of a bargain*. Neither extreme can have been meant. A midway between them must be hit.[79]

The municipality did not unilaterally thrust regulation on the utility. Rather, municipal regulation resulted from voluntary exchange: "It is true that the contract was in the form of an ordinance, but the ordinance was drawn as a contract to be accepted and it was accepted" by the utility.[80]

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77. *Id.* at 210. Later the same year, Justice Hughes wrote the opinion for a unanimous Court in New York Elec. Lines *v.* Empire City Subway Co., 235 U.S. 179 (1914), which posed the question of whether a franchise to use the streets of New York City to bury electrical lines constituted a contract and, if so, whether the contract had been unconstitutionally impaired. On the existence of the contract, Justice Hughes wrote:

> These municipal consents are intended to afford the basis of enterprise with reciprocal advantages, and it would be virtually impossible to fulfil the manifest intent of the legislature and to secure the benefits expected to flow from the privileges conferred, if, in the initial stages of the enterprise when the necessary proceedings preliminary to the execution of the proposed work are being taken with due promptness, or when the work is under way, the municipal consent should be subject to revocation at any time by the authorities—not upon the ground that the contract had not been performed, or that any condition thereof, express or implied, had been broken, but because as yet no contract whatever had been made and there was nothing but a license which might be withdrawn at pleasure. Grants like the one under consideration are not nude pacts, but rest upon obligations expressly or impliedly assumed to carry on the undertaking to which they relate. They are made and received with the understanding that the recipient is protected by a contractual right from the moment the grant is accepted and during the course of performance as contemplated, as well as after that performance.

Id. at 193 (citations omitted). Other early decisions concerning the regulatory contract addressed the municipality's power to reduce prices to uncompensatory levels. *See* SIDAK & SPULBER, *supra* note 11, at 153–60.

78. 223 U.S. 655, 669 (1912).

79. *Id.* at 669–70 (emphasis added).

80. *Id.* at 667–68.

E. The Evolution from Municipal Franchises to State Public Utilities Commissions

46. As the contract infringement cases indicate, by the late nineteenth century state legislatures had delegated to municipalities the power to award franchises. But, as one would expect of relational contracting, the utility franchises themselves evolved over time, ultimately creating administrative boards that were the precursors to the state public utilities commissions. Early franchises often were vague and left discretion to the utility company. City governments tried to stipulate more precise conditions in the franchise agreement, but changing economic and technological circumstances demanded greater flexibility, and the precise franchises grew to be unworkable. According to George L. Priest, the solution was to eliminate the restrictive details and introduce an administrative board, often having representatives from both the utility and the local government.[81] From those administrative boards grew the state regulatory commissions, most of which came into existence between 1907 and 1922.[82] Those state commissions gradually assumed the powers of the individual municipal franchise authorities in most states.[83]

47. Later, as the *Smith* decision in 1930 and the Commission's subsequent creation of the separations process attest, the federal government inserted itself into the regulatory contract concerning local telephony. It did so by altering the manner in which the recovery of a local exchange carrier's common costs could be recovered in the prices of interstate and intrastate services.

F. *Winstar* and the Unmistakability of the Regulatory Contract

48. The Supreme Court's 1996 decision in *United States* v. *Winstar Corporation*, while not addressing a regulated network industry, does indicate how the Court would likely view a case involving recovery of stranded costs arising from breach of the regulatory contract in such an industry.[84] Perhaps for that reason, public utilities commissions have been quick to assert that *Winstar* is irrelevant to the restructuring

81. George L. Priest, *The Origins of Utility Regulation and the "Theories of Regulation" Debate*, 36 J.L. & ECON. 289, 321 (1992). For a critique of Priest's article, see Geoffrey P. Miller, *Comment on Priest, "The Origins of Utility Regulation and the 'Theories of Regulation' Debate,"* 36 J.L. & ECON. 325 (1993).

82. "State regulatory commissions were first created in the late 1880s (in Massachusetts) but then were inaugurated with sudden uniformity in the decade and a half following 1907. By 1922, electric regulatory commissions had been introduced in thirty-seven of the forty-eight states and gas commissions in eighteen of the twenty large states." Priest, *supra* note 81, at 296. For the date of formation for each commission, see BARNES, *supra* note 39, at 206 chart 5.

83. For further discussion of this transition, see SIDAK & SPULBER, *supra* note 11, at 160–63.

84. 116 S. Ct. 2432 (1996).

of the regulated network industries.[85] It is not. To appreciate *Winstar*'s relevance to the regulatory contract, it is necessary first to review the essential facts of the case.

49. Three thrifts sued the United States for breach of contract after they had been declared in violation of the capital requirements of the new Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).[86] The thrifts argued that savings and loan regulators had promised to indemnify them from the type of regulatory change that FIRREA produced. During the savings and loan crisis of the 1980s, the Federal Home Loan Bank Board sought to induce healthy thrifts to merge with failing ones. The board signed agreements with the healthy thrifts that allowed them to count the excess of the purchase price over the fair market value of the acquired assets as an intangible asset—"supervisory goodwill"—that counted toward fulfilling capital reserve requirements. The board agreed to allow the healthy thrifts to amortize supervisory goodwill over twenty-five to forty years—an extended period that would give the healthy thrifts a reasonable opportunity to recover their costs of rehabilitating the sick thrifts. Without those regulatory agreements, the thrifts created by the mergers would have violated the capital reserve requirements. Thus, the healthy thrifts' investment in the sick thrifts never would have happened. Overall, however, the board's practice of encouraging such merged thrifts turned out to be a failure and promised to lead to the insolvency of federal deposit insurance funds for the thrifts. Eventually, Congress enacted FIRREA, which forbade thrifts from counting supervisory goodwill toward capital requirements. Regulators promptly seized and liquidated two of the three plaintiff thrifts in *Winstar* for failing to comply with the new capital reserve requirements; the third avoided seizure only by aggressively recapitalizing.

50. A plurality of the Supreme Court upheld the determination by the U.S. Court of Appeals for

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85. For example, New Hampshire's commission stated in 1997:

> Although *Winstar* has become a new rhetorical arrow in our utilities' empty quiver, *Winstar* need not give us pause. In *Winstar*, the threshold question, "whether there were contracts at all between the government and respondents[,]" was not before the Court. Therefore the case is of no assistance in determining whether a contract exists.

Restructuring New Hampshire's Electric Utility Industry, DR 96-150 Order No. 22,514, 175 P.U.R.4th 193 (N.H. Pub. Utils. Comm'n Feb. 28, 1997) (quoting *Winstar*, 116 S. Ct. at 2448). *But see* Electric Utility Industry Restructuring, Dkt. No. 95-462 (Maine Pub. Utils. Comm'n July 19, 1996) ("While not directly applicable, . . . *United States* v. *Winstar Corp.*, suggests, at least, that government should act responsibly in changing the 'rules of the game.'" (citation omitted)).

86. Pub. L. No. 101-73, 103 Stat. 183.

the Federal Circuit that the government had breached contractual obligations to the thrifts and was liable for breach of contract. One of the government's defenses was the "unmistakability" doctrine, under which surrenders of sovereign authority, to be enforceable, must appear in unmistakable terms in a contract. Justices David H. Souter, John Paul Stevens, Sandra Day O'Connor, and Stephen G. Breyer found that the defense did not apply to the contracts at issue, because the plaintiffs were suing not to stop the government from changing capital reserve requirements applicable to thrifts, but only to compel the government to indemnify them for the effects of such changes.[87] Justices Antonin Scalia, Anthony M. Kennedy, and Clarence Thomas did not accept that distinction between injunctive relief and damages but nonetheless found that the particular contracts at issue established that the government had unmistakably agreed to indemnify the thrifts.[88] Chief Justice William H. Rehnquist dissented in an opinion joined by Justice Ruth Bader Ginsburg.[89]

51. Writing for the majority, Justice Souter reasoned that application of the unmistakability defense "would place the doctrine at odds with the Government's own long-run interest as a reliable contracting partner in the myriad workaday transaction of its agencies."[90] The government would lose its ability to make credible commitments. "Injecting the opportunity for unmistakability litigation into every common contract action," Justice Souter wrote, "would . . . produce the untoward result of compromising the Government's practical ability to make contracts, which we have held to be 'the essence of sovereignty itself.'"[91] He further explained:

> The Court has often said, as a general matter, that the "rights and duties" contained in a government contract "are governed generally by the law applicable to contracts for private individuals." . . . This approach is unsurprising, for in practical terms it ensures that the government is able to obtain needed goods and services from parties who might otherwise, quite rightly, be unwilling to undertake the risk of government contracting.[92]

The plurality's reasoning in *Winstar* is directly analogous to the contractual issues that result from the mandatory unbundling of regulated network industries. Justice Souter noted that it is particularly important to

87. 116 S. Ct. at 2458 (Souter, Stevens, O'Connor, Breyer, J.J., plurality).
88. *Id.* at 2476 (Scalia, Kennedy, Thomas, J.J., concurring).
89. *Id.* at 2479 (Rehnquist, C.J., Ginsburg, J., dissenting).
90. *Id.* at 2459.
91. *Id.* (quoting United States *v.* Bekins, 304 U.S. 27, 51-52 (1938)).
92. *Id.* at 2473 (quoting Lynch *v.* United States, 292 U.S. 571, 579 (1934)).

treat the government's contracts with regulated firms as binding:

> It is important to be clear about what these contracts did and did not require of the Government. Nothing in the documentation or the circumstances of these transactions purported to bar the Government from changing the way in which it regulated the thrift industry. Rather . . . "the Bank Board and the FSLIC [the federal savings and loan insurance fund] were contractually bound to recognize the supervisory goodwill and the amortization periods reflected" in the agreements between the parties. We read this promise as the law of contracts has always treated promises to provide something beyond the promisor's absolute control, that is, as a promise to insure the promisee against loss arising from the promised condition's nonoccurrence. . . . *Contracts like this are especially appropriate in the world of regulated industries, where the risk that legal change will prevent the bargained-for performance is always lurking in the shadows.*[93]

That admonition is compelling where the government wishes to use contract as an instrument of regulation: "Since the facts of the present case demonstrate that the Government may wish to further its regulatory goals through contract, we are unwilling to adopt any rule of construction that would weaken the Government's capacity to do business by converting every contract it makes into an arena for unmistakability."[94] Thus, Justice Souter's reasoning in *Winstar* would apply even more forcefully to a regulated electric utility—which has made enormous, nonsalvageable investments in long-lived assets such as generation plants, transmission grids, and distribution networks—or to a local exchange carrier, which has made analogous investments in switching and transport facilities. Clearly, the logic of Justice Souter's plurality opinion extends to agreements that state or municipal regulators have made with private parties. It is permissible to bind those regulators even to commitments that are not "unmistakable" if the regulated firm seeks not to enjoin a change in regulatory policy, but only to receive financial compensation for the harm resulting from that change. Such a rule describes the situation in which an electric utility or local exchange carrier seeks not to enjoin statutes or regulations mandating network unbundling, but only to receive compensation for the stranded costs that result from such new laws.

52. More important than that distinction between remedies were Justice Souter's concluding remarks underscoring the Court's need to consider the contracts in the broader context of the parties' intent: "It would . . . have been madness for [the healthy thrifts] to have engaged in these transactions with no more

93. *Id.* at 2451-52 (quoting Winstar Corp. *v.* United States, 64 F.3d 1531, 1541-42 (Fed. Cir. 1995) (en banc) (emphasis added)).
94. *Id.* at 2460.

protection than the Government's reading [of the contracts] would have given them, for the very existence of their institutions would then have been in jeopardy from the moment their agreements were signed."[95] As noted earlier, the same reasoning about contractual intent permeates the Court's interpretations of the regulatory contract in the late nineteenth and early twentieth centuries. Not surprisingly, in *Winstar* Justice Souter[96]—and Justice Breyer in his concurrence[97]—relied upon those decisions construing the regulatory contract. Although Justice Souter could "imagine cases in which the potential gain might induce a party to assume a substantial risk that the gain might be wiped out by a change in the law, it would have been irrational in this case for [one of the healthy thrifts] to stake its very existence upon continuation of current policies without seeking to embody those policies in some sort of contractual commitment."[98]

53. In his concurrence, Justice Scalia believed that an enforceable duty imposed on the government to pay damages in the event of breach would "constrain the exercise of sovereign power" as much as compelling the government to perform the contract.[99] He thought that the unmistakability doctrine "has little if any independent legal force beyond what would be dictated by normal principles of contract interpretation."[100] In Justice Scalia's view the doctrine "is simply a rule of presumed (or implied-in-fact) intent."[101] He then offered a stark presumption of contract interpretation. Whereas Justice Souter feared that the government might lose its ability to make credible commitments, Justice Scalia implicitly assumed that the government had already lost it:

> Generally, contract law imposes upon a party to a contract liability for any impossibility of performance that is attributable to that party's own actions. That is a reasonable estimation of what the parties intend. When I promise to do x in exchange for your doing y, I impliedly promise not to do anything that will disable me from doing x, or disable you from doing y—so that if either of our performances is rendered impossible by such an act on my part, I am not excused from my obligation. When the contracting party is the government, however, it is simply *not* reasonable to presume an intent of that sort. To the contrary, it is

95. *Id.* at 2472.

96. *Id.* at 2449 (quoting The Binghamton Bridge, 70 U.S. (3 Wall.) 51, 78 (1866), for the proposition that the Court "refus[ed] to construe charter in such a way that it would have been 'madness' for private party to enter into it").

97. *Id.* at 2472–73 (Breyer, J., concurring) (citing *The Binghamton Bridge*, 70 U.S. (3 Wall.) at 74; Russell *v.* Sebastian, 233 U.S. 195, 205 (1914); Detroit *v.* Detroit Citizens' Street Ry., 184 U.S. 368, 384 (1902)).

98. *Id.* at 2449 (Souter, J., plurality).

99. *Id.* at 2476 (Scalia, J., concurring).

100. *Id.*

101. *Id.*

> reasonable to presume *(unless the opposite clearly appears)* that the sovereign does *not* promise that none of its multifarious sovereign acts, needful for the public good, will incidentally disable it or the other party from performing one of the promised acts. The requirement of unmistakability embodies this reversal of the normal reasonable presumption. Governments do not ordinarily agree to curtail their sovereign or legislative powers, and contracts must be interpreted in a common-sense way against that background understanding.[102]

If it were unreasonable *as a matter of law* for a private party to trust the government's contractual promise, contract negotiations with the government would entail higher transaction costs, and private parties to such contracts would demand a substantial risk premium, as such parties do when contracting with the governments of politically unstable nations.

54. Justice Scalia's skepticism about the appropriate legal presumption concerning contractual intent did not prevent him from concluding that the three thrifts had "overcome this reverse-presumption that the Government remains free to make its own performance impossible through its manner of regulation."[103] In reasoning reminiscent of the Court's early interpretations of regulatory contracts in cases such as *The Binghamton Bridge*,[104] *Walla Walla Water*,[105] *Russell* v. *Sebastian*,[106] and *Detroit Citizens' Street Railway*,[107] Justice Scalia agreed with the thrifts that "the very *subject matter* of these agreements, an essential part of the *quid pro quo*, was government regulation" and that "unless the Government is bound as to that regulation, an aspect of the transactions that reasonably must be viewed as a *sine qua non* of their assent becomes illusory."[108] He rejected the notion that "unmistakability demands that there be a *further* promise not to go back on the promise to accord favorable regulatory treatment."[109] The unmistakability doctrine does not require a private party to demand "the Government's promise to keep its promise."[110] Echoing as Justice Souter did the reasoning in the Court's early decisions on regulatory contracts, Justice Scalia stressed the relationship between cost recovery, contract duration, and consideration: "[I]t is quite

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102. *Id.* (emphasis in original).
103. *Id.*
104. 70 U.S. (3 Wall.) 51, 73 (1866).
105. Walla Walla City *v.* Walla Walla Water Co., 172 U.S. 1, 17–18 (1898).
106. 233 U.S. 195, 206–07 (1914).
107. Detroit *v.* Detroit Citizens' Street Ry., 184 U.S. 368, 385 (1902).
108. *Winstar*, 116 S. Ct. at 2477 (emphasis in original).
109. *Id.* (emphasis in original).
110. *Id.* at 2478.

impossible to construe these contracts as providing for only 'short term' favorable treatment, with the long term up for grabs: either there was an undertaking to regulate [the healthy thrifts] as agreed for the specified amortization periods, or there was no promise regarding the future at all—not even so much as a peppercorn's worth."[111]

55. What conclusions does one therefore draw from reconciling Justice Souter's plurality opinion with Justice Scalia's concurrence? Only four Justices in *Winstar* would interpret the unmistakability doctrine to permit damage remedies in cases where it was not unmistakable that the government had contracted to retain an existing regulatory regime for the benefit of the regulated firm. Of far greater consequence for the restructuring of the regulated network industries, however, is the fact that *seven* Justices—Breyer, Kennedy, O'Connor, Scalia, Souter, Stevens, and Thomas—supported their divergent legal conclusions with the same economic reasoning that stressed cost recovery, incentive for investment, opportunism, and the government's need to make credible commitments. In that important respect, *Winstar* builds on the intellectual foundation that such justices as Holmes, Hughes, Harlan, and Taft laid more than a century earlier to construe the rights and remedies of public utilities under their regulatory contracts with municipalities. *Winstar* confirms the continued vitality of the reasoning in those early decisions.

V. The Takings Clause Obligates the Commission and the States to Ensure that Their Separations Rules Give an ILEC a Reasonable Opportunity to Recover All of Its Costs

56. Like the regulatory contract, the Takings Clause of the U.S. Constitution imposes an analogous constraint on the Commission and the states to ensure that rules that they adopt for allocating costs across the state and federal jurisdictions do not deny the ILEC its reasonable opportunity to recover its full costs of providing service. As regulators dismantle barriers to entry and other regulatory restrictions, they must honor their past commitments concerning cost recovery and must avoid actions that threaten to confiscate or destroy the property of utility investors.

57. The Supreme Court has placed takings cases into three categories. In declining order of

111. *Id.* at 2477–78.

judicial solicitude given the property owner, the categories are physical invasions of property; confiscatory public utility rates; and regulatory takings. Breach of the regulatory contract does not fit automatically into any one of those categories because, being unprecedented, it necessarily is a case of first impression under the Takings Clause. That is true even with respect to the precedents addressing public utility regulation. Ultimately, first principles of legal and economic theory will determine a deregulatory taking as an event necessitating the state's payment of just compensation. Close examination of the Court's reasoning supports the conclusion that, under all three branches of existing takings jurisprudence, the regulator's abrogation of the regulatory contract would be a compensable confiscation of the property of the regulated firm. That result holds whether one casts a deregulatory taking as a physical invasion of property, as a confiscatory setting of public utility rates, or as a noninvasive regulatory taking.

A. Regulatory Takings and the Destruction of the ILEC's Investment-Backed Expectations

58. The least-protected class of government confiscation of property, regulatory takings have produced an analytical model in the Supreme Court that is only occasionally hospitable to the plight of land owners subjected to land use or environmental restrictions. Nonetheless, the straightforward application of that same model to the government's repudiation of the regulatory contract produces, even at this lowest level of judicial solicitude, powerful protection for the property of the incumbent utility.

1. Legal Criteria Concerning Regulatory Takings

59. The law of regulatory takings has descended from Justice Holmes's "general rule" announced in *Pennsylvania Coal Co.* v. *Mahon* in 1922, a rule most notable for its utter lack of guidance: "while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking."[112] For half a century the Court gave little guidance as to what "too far" meant. In 1978 Justice Brennan, writing for the Court in *Penn Central Transportation Co.* v. *New York City*, finally attempted to provide such guidance: A regulation constitutes a taking if it denies the property owner "economically viable use" of that property, which is to be determined by examining the following three factors: (1) the "character of the

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112. 260 U.S. 393, 415 (1922).